

# Overdraft Protection Programs

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The Department has become aware that several banks have implemented various vendor-designed or in-house Programs to generate income resulting from consumers writing checks without sufficient funds to cover the checks. There are several variations of such Programs. Recently four on-site examinations of such Programs were conducted.

Of the banks examined most offer the Program to each consumer checking account customer whose account is in good standing. Each bank defines good standing individually; however, most include some variation of the following:

1. The account must be open for at least 30 - 60 days.
2. Make at least two deposits during the first 30 - 60 days.
3. Deposit at least \$1,000 total during the first 30 - 60 days.
4. Continue to make regular deposits consistent with past practices.
5. Not be in default on any loan obligations to the bank.
6. Not be subject to any legal or administrative order or levy.

It was noted, the term “regular deposits” was customized for each individual bank. For example, one bank defined regular deposits as making a \$500 or more deposit in the account in each 30-day period while another bank defined it simply as bringing the account to a positive balance at least once every 30 days.

The Overdraft Programs offer all consumers in good standing a coverage limit ranging from \$300 to \$1,000. The customer is not required to apply for the Program or sign anything. Customers can access the program as follows:

1. Checks and other debits cashed at the teller windows.
2. Checks issued to a third party.
3. Check Card or ATM card.
4. Through online banking or voice banking line.
5. ACH debit transactions.
6. Any other transactions honored through a personal checking account.

In all instances the customer’s account is charged the bank’s standard overdraft fee usually \$20.00-\$25.00 for each item presented for payment. Some banks also assess a per day fee as long as the account contains a negative balance. In most instances the customer has 30 days to bring the account to a positive balance.

If the account is not brought to a positive balance within 30 days, the customer must sign an agreement to pay the overdraft in installments; usually no additional charges, fees, or finance charges are imposed. Assuming the original extension of credit was not subject to Regulation Z and the consumer is in default, a new agreement permitting the consumer to pay the delinquent debt in installments would not be subject to Regulation Z unless the rate is increased, or the new amount financed exceeds the unpaid balance plus accrued fees. (Regulation Z, Section 226.20)

Generally, banks do not market the Program on television or radio. Brochures and printed ads for checking accounts simply mention that the Program is available. Some documents are more specific, for example one bank’s website and several banks’ brochures contain statements such as:

Save yourself embarrassment and fees when you make an honest mistake in your check-book, have an unexpected emergency or run short of cash between paydays. Instead of returning checks unpaid, the bank Program will automatically pay them up to a pre-determined limit.

You can access the bank Program through checks, automatic withdrawals, your check card or ATM card, online banking and voice banking line. As long as you stay under your limit, all overdrafts will be approved. After using the Program, you have thirty days to bring your account to a positive balance.

Most of the banks examined also offered a traditional overdraft line of credit account.

## IC 24-4.5 INDIANA UNIFORM CONSUMER CREDIT CODE:

IC 24-4.5-3-106 defines a loan to include:

- (1) the creation of debt by the lender’s payment of or agreement to pay money to the debtor or to a third party for the account of the debtor;
- (2) the creation of debt by a credit to an account with the lender upon which the debtor is entitled to draw immediately;
- (3) the creation of debt pursuant to a lender credit card or similar arrangement; and
- (4) the forbearance of debt arising from a loan.

Note IC 24-4.5-3-106 does not require a written agreement, and IC 24-4.5-1-301(1) defines agreement to mean the bargain of the parties in fact as found in their language or by implication from other circumstances, including course of dealing or usage of trade or course of performance.

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IC 24-4.5-3-104 defines a consumer loan as a loan made by a person regularly engaged in the business of making loans in which:

- (a) the debtor is a person other than an organization;
- (b) the debt is primarily for a personal, family, or household purpose;
- (c) either the debt is payable in installments or a loan finance charge is made; and
- (d) either the principal does not exceed fifty thousand dollars or the debt is secured by an interest in land or by personal property used or expected to be used as the principal dwelling of the debtor.

IC 24-4.5-3-109 defines loan finance charge to be the sum of :

- (a) all charges payable directly or indirectly by the debtor and imposed directly or indirectly by the lender as an incident to the extension of credit, including any of the following types of charges which are applicable: interest or any amount payable under a point, discount, or other system of charges, however denominated, premium or other charge for any guarantee or insurance protecting the lender against the debtor's default or other credit loss; and
- (b) charges incurred for investigating the collateral or credit-worthiness of the debtor.

To determine if the banks' fees for coverage of an overdraft are finance charges under IC 24-4.5, transactions conducted on accounts with the protection of the Program must be compared to transactions conducted on accounts without the protection of such Program.

Comparison 1:

A consumer who has a \$0.00 balance in his or her checking account writes a check to a grocery store for \$125.00. If the consumer has the protection of the Program, the check is covered and the consumer is charged a standard overdraft fee (\$20.00-\$25.00). At some banks the consumer may also be charged a \$5.00 per day fee until the account is brought to a positive balance. If the consumer does not have the protection of the Program, the bank may or may not choose to cover the check. If the bank chooses to cover the check, the consumer is charged a standard NSF fee (\$20.00-\$25.00) and at some banks a \$5.00 per day fee. If the bank chooses not to cover the check the consumer is charged a standard NSF fee (\$20.00-\$25.00) and no per day fee. The customer may also be charged an NSF fee by the merchant.

In this comparison the standard overdraft fee (\$20.00-\$25.00) charged to the consumer would not be a finance charge under IC 24-4.5 because the charge is not imposed as an incident to the extension of credit. Some proponents state that the \$5.00 per day fee is not a finance charge provided the bank contracts for a per day fee in the checking account agreement that they have with all customers. Although a \$5.00 per day fee would never be imposed if the bank chooses not to cover the check, the bank is contractually able to cover the check on an account without the protection of the Program and impose the \$5.00 per day fee. Others state that per day fees assessed in connection with the protection of the Program are finance charges because per day fees are assessed as an incident to or a condition of the extension of credit.

Comparison 2:

A consumer who has a \$0.00 balance in their checking account attempts to make a \$200.00 withdrawal at an ATM. If the consumer has the protection of the Program, the consumer receives \$200.00 from the machine and is charged a standard overdraft fee (\$20.00-\$25.00) for this service. At some banks the consumer may also be charged a \$5.00 per day fee until the account is brought to a positive balance. If the consumer does not have the protection of the Program, the consumer receives \$0.00 from the machine and is charged nothing for making the attempt.

In this comparison the standard overdraft fee (\$20.00-\$25.00) and any per day fee charged to the consumer could be finance charges because the charges are assessed as an incident to or a condition of the extension of credit.

**In reference to the Programs offered by the banks where consumers overdraft their accounts in any manner except by a check to a third party:**

- (a) the debtor is a person other than an organization;
- (b) the debt is primarily for a personal, family, or household purpose;

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- (c) a loan finance charge is made (a fee is imposed and is payable directly by the debtor and is imposed directly by the lender as an incident to the extension of credit); and
- (d) the principal does not exceed fifty thousand dollars.

Some proponents of such Programs have revised their Program to make it clear that there is a contractual written agreement between the bank and the customer. However, they state that their Program is not a “consumer loan” because the charge per item is the same to all depository customers; therefore, a finance charge is not being imposed. There is also no per day fee assessed.

However, the Programs offered by the banks where consumers are assessed fees as an incident to the extension of credit, such as accessing the Program through an ATM, could be subject to IC 24-4.5. All charges imposed as an incident to the extension of credit are loan finance charges and the loans made may be considered usurious under IC 35-45-7-2, and considered loan sharking, a felony. This issue may have to be resolved by a court in Indiana.

### REGULATION Z, THE TRUTH-IN-LENDING ACT: (12 CFR 226 and IC 24-4.5-3-301)

The key issue under Regulation Z is whether an agreement exists between the bank and the accountholder to which the bank will honor an overdraft. Regulation Z, Section 226.4(c) (3) of the Official Staff Commentary clarifies charges imposed by a financial institution for paying items that overdraw an account are excluded from the finance charge unless the payment of such items and the imposition of the charge (**per item fee and/or per diem fee**) were previously agreed upon in writing. Therefore, proponents state that as long as the financial institution does not agree in writing to pay such overdrafts, a charge assessed to a consumer for overdrawing an account, whether it is a per item fee or a per diem fee, will never be a finance charge for disclosure purposes under Regulation Z.

Some proponents of such Programs have revised their Program to make it clear that there is a contractual written agreement between the bank and the customer.

Others state that their Program is not subject to Regulation Z because there is not a “written agreement” between the bank and the accountholder to which the bank will honor an overdraft. (Regulation Z, Section 226.1(c)) However, many accountholders are receiving various correspondences and marketing materials containing language that may be interpreted as a written agreement in which the accountholder relies on the bank to cover their overdrafts making the Program subject

to Regulation Z. For example:

- Many of the Programs have an overdraft policy containing language similar to, the bank is not obligated to pay any item presented for payment if the account does not contain sufficient funds and normally we will not approve an overdraft for you in excess of **the pre-determined** amount assigned to your account.
- In some correspondences and or marketing materials the bank is using phrases such as; The Program **will provide** you a safety net that **will permit** you to overdraft your account... and ...we **will honor** overdrafts... and ... the bank **will pay** the item... and ...you **will** be authorized to withdraw money from the ATM up to the full amount of your Program limit.
- The available balance, in some instances, is being reflected on the accountholders ATM receipts, overdraft letters, and is being disclosed through the bank's 24-Hour Touch Tone Banking system.

The Administrators of the Programs intend the non-binding obligation language used in certain of these documents to remove the existence of any written agreement to honor overdrafts. But the mere fact that these same documents also indicate that the Bank contemplates honoring overdrafts as a general banking policy when certain conditions are met conceivably could be sufficient to constitute the requisite written agreement.

Assuming there is an agreement between the bank and the accountholder raises another Regulation Z issue, whether the fee charged in connection with the overdraft is a “finance charge?” Section 226.4(b)(2) of Federal Regulation Z provides service, transaction, activity, and carrying charges, including any charge imposed on a checking or other transaction account to the extent that the charge exceeds the charge for a similar account without a credit feature, are finance charges. Therefore, to determine if the bank's overdraft fee is a finance charge, transactions conducted on accounts with coverage must be compared to transactions conducted on accounts without coverage.

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To illustrate; an accountholder has \$0.00 in his checking account and uses a debit card to pay for a \$200 bill at a grocery store. If the accountholder has a credit feature, the transaction is approved. The consumer leaves the store with \$200 in groceries and is charged \$20.00. If the consumer does not have a credit feature, the grocery store electronically inquires to determine if the consumer has sufficient funds available to cover the \$200 grocery bill. If not, the consumer leaves the store with no groceries and no fee is imposed.

Regulation Z, Section 226.4(b)(2) and the Official Staff Commentary provides that fees imposed for paying an item that overdraws an account with a credit feature are not finance charges unless the fees exceed the charge for a similar account without a credit feature. Any amounts imposed in excess of the charge for a similar account without a credit feature would be finance charges.

Although no fee is imposed in the above illustration for electronically rejecting the item, the Bank is contractually able to pay the item on a similar account without a credit feature and assess a \$20.00 overdraft fee. This principle works the same if a per diem fee is imposed as long as the Bank contracts for overdraft fees (to include a per diem fee) in the checking account agreement. Therefore, these fees (including a per diem fee) are not finance charges under Regulation Z for disclosure purposes.

## OTHER AREAS OF CONCERN AND QUESTIONS:

Although there are apparent differences in the implementation/underwriting of the Program at the various participating institutions, the following are several areas of concern and questions that were common among the majority of the participating banks.

- In most cases, as long as the consumer maintains an account in good standing (defined as making regular deposits and bringing the account to a positive balance at least once every 30-60 days) the bank may honor overdrafts up to the Program's limit. A new account holder who has maintained a personal checking account in good standing, will be able to use the Program 30-60 days after the account has been opened. Is 30-60 days long enough to determine if an account is in good standing? Can the bank establish an accountholder is making regular deposits in a 30-60 day period?
- In some of the banks, the decision to pay an overdraft item on accounts with the Program is usually auto-

matic, via the bank's computer system, provided there is a sufficient dollar amount available within the Program's available limit. However, once an account is given access to the Program there is not a system in place to verify if the accountholder is still in good standing and making regular deposits. For example, an accountholder may not have made a deposit for 180 days and yet the bank's computer system will automatically pay an overdraft. Should there be a system in place to verify the accountholder is still in good standing before paying an overdraft?

- In the majority of the banks, there were no controls on how many times an accountholder could access the Program. For example, an accountholder can access the Program for \$400 on the 20<sup>th</sup> of each and every month and pay it back on the 1<sup>st</sup> when he gets paid. Therefore, a consumer may be able to use the Program as a regular source of cash as he runs short each and every month. This could lead to a type of "debt treadmill" situation. The customer is in a situation where he or she may become obligated for more in fees than the original principal amount.
- No cooling off period exists following repayment of an overdraft during which no overdrafts would be paid, thus increasing the likelihood a customer would consciously resort to the Program to pay for ordinary day-to-day expenses.
- An unlimited number of overdraft charges, in the majority of the banks reviewed, could be levied during a 30-day period as long as the accountholder did not exceed his or her Program limit. It was further noted, some of the banks changed their method of paying checks from a low to high sequence to a serial number order with the sole purpose of increasing their fee income.
- If the program is intended to cover accountholders when they inadvertently overdraw their account, why is there a need for a \$1,000 available limit?
- Are the depository institutions informing accountholders of available alternatives for short-term borrowing, explaining the costs and advantages of various alternatives such as a traditional overdraft line of credit? Is the institution doing anything in terms of educating the consumer about the importance of wise money management? Is the institution identifying possible contingent liability risks if they were to be sued under this program? Has the bank's Board of Directors been made aware of the program and possible contingent liabilities?

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- Has the depository institution obtained third party legal advice prior to entering into the Program including a review of the OCC Interpretive Letter #914 from September of 2001 and the DFI overdraft advisory dated February of 2002? This advice should be independent of any legal advice from an attorney representing a third party vendor who is marketing the program to the bank.
- In some circumstances, the charges assessed on accountholders may be just as burdensome or more so as those imposed on borrowers utilizing other types of high interest rate credit such as payday loans.
- Is the institution aware the Federal Reserve is concerned about these programs and is presently seeking public comment in a proposed rule 12 CFR 226 Docket No. R-1136-Comment is being sought as to how such charges are to be treated under Regulation Z and other consumer laws.
- Has the bank fully considered the public policy issues regarding encouraging customers to write checks on funds that are not available where it is obvious that such programs exist primarily to generate and increase fees.

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